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529 College Savings Plans

A brief history

529 plans were created by Congress in 1996 and have been modified through the years by various pieces of legislation. Known officially as "qualified tuition programs" or QTPs, 529 plans are so named because they are governed by section 529 of the Internal Revenue Code.

529 savings plans are tax-advantaged education savings vehicles and one of the most popular ways to save for college today. They can also be used to save for K-12 tuition. Much like the way 401(k) plans changed the world of retirement savings a few decades ago, 529 savings plans have changed the world of education savings.

Tax advantages and more

529 savings plans offer a unique combination of features that no other education savings vehicle can match:

- Federal tax advantages: Contributions to a 529 account accumulate tax deferred and earnings are tax free if the money is used to pay the beneficiary's qualified education expenses. (The earnings portion of any withdrawal not used for qualified education expenses is taxed at the recipient's rate and subject to a 10% penalty.)
- State tax advantages: States are free to offer their own tax benefits to state residents, such as a tax deduction for contributions.
- High contribution limits: Most plans have lifetime limits of $350,000 and up (limits vary by state).
- Unlimited participation: Anyone can open a 529 savings plan account, regardless of income level.
- Wide use of funds: Money in a 529 savings plan can be used to pay the full cost (tuition, fees, room, board, books, supplies) at any accredited college or graduate school in the United States or abroad; for certified apprenticeship programs (fees, books, supplies, equipment); for student loan repayment (there is a $10,000 lifetime limit per 529 plan beneficiary and $10,000 per each of the beneficiary's siblings); and for K-12 tuition expenses up to $10,000 per year.
- Professional money management: 529 savings plans are offered by states, but they are managed by designated financial companies who are responsible for managing the plan's underlying investment portfolios.
- Flexibility: Under federal rules, you are entitled to change the beneficiary of your account to a qualified family member at any time as well as roll over (transfer) the money in your account to a different 529 plan once per calendar year without income tax or penalty implications.
- Accelerated gifting: 529 savings plans offer an estate planning advantage in the form of accelerated gifting. This can be a favorable way for grandparents to contribute to their grandchildren's education while paring down their own estate, or a way for parents to contribute a large lump sum. Under special rules unique to 529 plans, a lump-sum gift of up to five times the annual gift tax exclusion amount ($15,000 in 2021) is allowed in a single year, which means that individuals can make a lump-sum gift of up to $75,000 and married couples can gift up to $150,000. No gift tax will be owed, provided the gift is treated as having been made in equal installments over a five-year period and no other gifts are made to that beneficiary during the five years.
- Transfer to ABLE account: 529 account owners can roll over (transfer) funds from a 529 account to an ABLE account without federal tax consequences. An ABLE account is a tax-advantaged account that can be used to save for disability-related expenses for individuals who become blind or disabled before age 26.

Choosing a 529 savings plan

Although 529 savings plans are governed by federal law, their implementation is left to the states. Currently, there are over 50 different savings plans available because many states offer more than one plan.

You can join any state's 529 savings plan, but this variety may create confusion when it comes time to select a plan. Each plan has its own rules and restrictions, which can change at any time. To make the process easier, it helps to consider a few key features:

Put your savings effort on autopilot

Consider linking your 529 savings plan to your bank account so you can easily make automatic monthly contributions.

- Your state's tax benefits: A majority of states offer some type of income tax break for 529 savings plan participants, such as a deduction for contributions or tax-free earnings on qualified withdrawals. However, some states limit their tax deduction to contributions made to the in-state 529 plan only. So make sure to understand your state's rules.
- Investment options: 529 savings plans vary in the investment options they offer. Ideally, you'll want to find a plan with a wide variety of investment options that range from conservative to more growth-oriented to match your risk tolerance. To take the guesswork out of picking investments appropriate for your child's age, most plans offer aged-based portfolios that automatically adjust to more conservative holdings as your child approaches college age. (Remember, though, that any investment involves risk, and past performance is no guarantee of how an investment will perform in the future. The investments you choose may lose money or not perform well enough to cover college costs as anticipated.)
- Fees and expenses: Fees and expenses can vary widely among plans, and high fees can take a bigger bite out of your savings. Typical fees include annual maintenance fees, administration and management fees (usually called the "expense ratio"), and underlying fund expenses.
- Reputation of financial institution: Make sure that the financial institution managing the plan is reputable and that you can reach customer service with any questions.
- User experience: Is the plan's website easy to use? Can you easily take care of routine tasks online, such as set up automatic monthly contributions, change your contribution amount, research plan investments, find your rate of return, or request a withdrawal?

With so many plans available, it may be helpful to consult an experienced financial professional who can help you select a plan and pick your plan investments. In fact, some 529 savings plans are advisor-sold only, meaning you must go through a designated financial advisor to open an account.

Account mechanics

Once you've selected a plan, opening an account is easy. You'll need to fill out an application, where you'll name a beneficiary and select one or more of the plan's investment portfolios to which your contributions will be allocated. Also, you'll typically be required to make an initial minimum contribution, which must be made in cash or a cash alternative.

Thereafter, most plans will allow you to contribute as often as you like. This gives you the flexibility to tailor the frequency of your contributions to your own needs and budget, as well as to systematically invest your contributions by setting up automatic monthly transfers from your bank account.

As for investment changes, beware that under federal law you are allowed to exchange your existing plan investments for new investments only twice per year. In other words, if your existing plan funds are currently invested in plan portfolios A & B but you want to change them to plan portfolios C & D, you can do this only twice per calendar year. However, you generally have unlimited say in how your *future* contributions will be invested.

You will also be able to change the beneficiary of your 529 savings account to a qualified family member with no income tax or penalty implications.

529 prepaid tuition plans — a distant cousin

There are actually two types of 529 plans — savings plans and prepaid tuition plans. The tax advantages of each are the same, but the account features are very different. A prepaid tuition plan lets you prepay tuition at participating colleges, typically in-state public colleges, at today's prices for use by the beneficiary in the future. 529 prepaid tuition plans are generally limited to state residents, whereas 529 savings plans are open to residents of any state. Prepaid tuition plans are much less common than savings plans.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing; specific plan information is available in each issuer's official statement. There is the risk that investments may not perform well enough to cover college costs as anticipated. Also, before investing, consider whether your state offers any favorable state tax benefits for 529 plan participation, and whether these benefits are contingent on joining the in-state 529 plan. Other state benefits may include financial aid, scholarship funds, and protection from creditors.*

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